

FYI

Ask Abo and Company... For What it's Worth A Special Report on Valuation Issues

Valuing Employee Damages

Damages in employee discrimination cases can be difficult to quantify and require the expertise of an experienced financial consultant. Often referred to as "compensatory" damages and consisting of either back pay, front pay or both, these damages usually are based on what would be required to return the employee claiming discrimination to the position he or she would have attained if the discrimination had not occurred.

Several factors are involved in making this determination. A financial expert engaged for such a matter must use sound professional judgment while it's certainly beneficial to be familiar with employment law and the basic economic principles used in applying it.

Back Pay

The attorney frequently requests the expert to calculate back pay from the date of the alleged wrongful termination to the date of the trial. Depending on the type of discrimination, back pay may also be extended for a certain period before the termination. It may incorporate several categories of income, such as wages, salary, fringe benefits, overtime pay, raises, cost-of-living adjustments, bonuses, shift differentials, health insurance, retirement contributions, stock options, etc.

To calculate the back pay amount via the individualized method the expert may need to:

- Reconstruct the victim's employment history
- Determine the appropriate time period
- Identify all wage and fringe benefits to include in the calculation
- Determine whether the victim's mitigation obligations have been met
- List any amounts that should reduce the award, such as salary from other employment or interim earnings
- Subtract these amounts from the dollar amount
- Determine the prejudgment interest to be paid

Front Pay

Victims of discrimination may also suffer future, or front pay, damages. If such a victim is not able to obtain his or her rightful position as a result of the alleged discrimination, and that position paid a higher salary than the position now available to that individual, he or she may be entitled to compensation based on this discrepancy. Front pay usually consists of lost wages that a victim is reasonably certain to incur in the future, less any income from other employment. The expert generally tries to refrain from estimates based largely on speculation, and may need to reduce any awards to present value.

Determining Damages Is a Complex Process

Each employee damages case has a unique set of assumptions based on its own particular circumstances, and must be approached individually. Candidly, the first place to seek assistance is from a qualified labor attorney and, if you need one, you now should realize we'd be happy to recommend one or more credible lawyers seasoned in employment law. If the attorney or you have any questions about the valuation process or would like help in determining the amount of damages in specific cases, we should be given a call, as well. We may be able to provide advice tailored to your situation. Of course, after we, or another expert determines, the damages, legal counsel may need to evaluate the impact of liability or other legal issues on this amount.



Inside this Issue...

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Different Values for Different Purposes

Value is a meaningless term by itself because it can mean so many different things. A value found for one purpose can be entirely different from the value for another. Understanding exactly what type of value you are looking for can make the information you obtain from the valuation much more useful. Here's a look at some of the many kinds of value:

Book value: Not a standard of value at all. Book value is an accounting term for the total net assets minus total liabilities on the balance sheet. Intangible assets, unless purchased, are usually excluded from book value.

Fair market value: Fair market value is generally defined as, "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." This definition and the standards for fair market value were set by the Internal Revenue Service in Revenue Ruling 59-60. The definition suggests that fair market value cannot result from purely subjective factors such as sentimental value. It also cannot result from a forced sale, or one resulting from an unusual or rigged market. It is used for federal and state tax matters, including gift, estate, income and inheritance taxes.

Fair value: Statutory standard of value usually used in court cases involving dissenting shareholders' litigation. Court precedent in most states has not equated fair value with fair market value, but the courts have reached little other consensus on its meaning. In real estate appraisals, on the other hand, fair value is often used synonymously with fair market value.

Liquidation value: Liquidation value is the value derived from the piecemeal sale of assets. The sale can be orderly or forced, which can affect the value. Liquidation value is typically at the low

end of the value spectrum.

Intrinsic value: Subjective value of an entity to an owner/buyer. Intrinsic value may exclude current market influences. It also may include consideration of such things as the company's assets, and its likely future earnings, dividends and growth rate.

Investment value: Value to a particular buyer or investor considering his or her specific personal circumstances, knowledge of the transaction and potential synergies. This value can be higher or lower than the company's fair market value.

Enterprise value: Value of 100% of the shareholders' equity on a control basis. Invested capital value: Fair market value of 100% of the equity plus the market value of long-term debt.

Minority value: Value reflecting an ownership position of less than 50%.

Control value: Additional value inherent in a legally controlling interest, reflecting the power of control over the business.

Marketable value: Value of an equity assuming a pre-established market in which that equity can be exchanged.

Private company value: Opposite of marketable value. Private company value represents a decreased value due to the limitations in the equity's marketability.

Choosing the Wrong Value May Be Costly

It's important to know what base type of value (i.e., minority, marketable) you're starting with before any discounts or premiums are applied. Relying on the wrong type of value may be quite an expensive mistake. Understanding the differences between standards of value can help you interpret their relative worth in your situation.

We would be happy to answer any questions you might have about value, or to help you determine what kind is best for your purposes. Please call us for assistance with these or other valuation matters.

Protect Your Heirs: Business Valuation and the Estate Plan

When you are involved in planning your estate, you probably want to pass as much to the heirs as possible. When the estate planning strategy involves a business you own, it should also include a business valuation. Commissioning a valuation of your entire company, then arbitrarily dividing it into segments for each heir, distorts the results and could leave your heirs facing substantial unplanned consequences.

These consequences can stem from changes in the share value if it's divided among several heirs. Why? The value of a minority interest reflects different discounts from the pro-rata value of a majority interest. The potential of a swing-vote situation may also affect the value of any shares being gifted to family members. You need to be clear on the business interest being valued.

Choosing a Valuation Method

No single valuation method does the entire job. However, failure to use a method without a valid explanation may result in a challenge from the Internal Revenue Service (IRS). Many small business owners base their stock prices on the average of their business' earnings over a period of years, using either a weighted or a simple average. This method for finding value often does not pass IRS scrutiny.

A business valuation is like a three-legged stool — it won't stand up without all the components. To arrive at a reasonably accurate final number, the valuation must consider all three legs: cost, income and market data, although certain methods may be eliminated if they're not applicable. Relying on a valuation performed by someone who is not a valuation professional is a risky practice that could lead to the IRS refuting the valuation.

The Importance of Valuations

A valuation can be an effective planning tool for estates that include a business interest. A valuation that considers all the implications in the estate plan will identify the estate tax burden of the plan and reduce the chances of facing unexpected IRS penalties.

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Factors to Consider in Valuing a Closely Held Business

Many owners of closely held businesses assume they have a pretty good idea of their businesses' value. Often an owner may decide his or her company's value based simply on cash flow and profit margin. While determining the value of a closely held business may appear to be a straightforward process, it is actually quite complex, involving consideration of numerous factors. A valuator should understand their impact and, more important, know how to combine them to derive a reasonable, well-supported value.

The data that a valuation professional relies on will vary from one case to the next. Common documents include:

- Historical financial statements
- Business plans and financial projections
- Advertising and professional literature
- Bank loan agreements
- Backlog information
- Income tax returns
- Asset appraisals
- Long-term contracts
- Leases
- Buy-sell agreements
- Price lists, procedures manuals and other internal documents used to manage the business

After gathering background information, a valuator normally visits the company's facilities and interviews management. The visit can take from a few hours to a few days and may require follow-up visits to fill in information gaps.

The valuator may search for information regarding the company and its industry to add to this foundation, including:

- Industry data
- Economic forecasts
- Rates in the financial markets
- Pricing data from acquisitions of similar businesses
- Relevant pricing data from public equity markets

To give you an idea of the factors a valuator typically considers, here's a brief overview.

Competition

Fundamental to a determination of a closely held company's value, competition encompasses a number of categories, including the company's:

- Relative size compared with other businesses in its industry
- Relative product or service quality
- Product or service differentiation from others in the industry
- Market strengths
- Market size and share
- Competitiveness within its industry in terms of price and reputation
- Copyright or patent protection of its products

Management Ability

Is management skilled and experienced enough to keep the company at the top of its game for the foreseeable future? Several factors can indicate management ability:

- Accounts receivable, inventory, fixed asset and total asset turnover,
- Employee turnover
- Condition of the facilities
- Family involvement, if any
- Quality of books and records
- Sales as well as gross and operating profit

Financial Strength

Consideration of financial strength entails a number of ratios, including a company's:

- Total debt to assets
- Long-term debt to equity
- Current and quick ratios
- Interest coverage
- Operating cycle

Profitability and Stability of Earnings

Another important factor is the financial stability of the company, as revealed by its profitability during its operating history, including:

- The number of years the company has been in business and its sales and earnings trends
- The life cycle of the industry as a whole
- The returns on sales, assets and equity

Other Factors

As if this were not enough, the valuator also should consider the economic conditions in which the company is operating, including the broad industry outlook and the impact of various Internal Revenue Service (IRS) rulings and court cases that may affect the company's value. In addition, the valuator will often analyze restricted stock studies and the values of comparable companies to determine their relationship to the company's value. Intangible factors such as goodwill value and noncompete agreements can be significant as well.

Finally, the valuator needs to determine the discount or capitalization rate of the company, specify what percentage of the company is being valued, and take into account any marketability or minority interest discounts.

Putting It All Together

Perhaps the most difficult part of the entire process is knowing how to combine all of these factors in a meaningful way to reach a value that will aid in withstanding challenges by potential buyers, the IRS, dissatisfied partners or others. A valuator with professional training, experience and expertise should be able to accomplish this.

Please give us a call with any questions or problems concerning valuation matters. We would be glad to help.



Each month more than 45,000 business owners and individuals find valuable information on our website which is done in-house and updated constantly. Check us out at www.aboandcompany.com

Finding the Value of a Business in a Divorce

On top of all the other complex, difficult processes involved in a divorce, if one or both spouses own a business, you should add a valuation. A divorce valuation goes by special rules. For example, one aspect of finding value for a divorce settlement is that you are not seeking the investment value of the business. Because the business usually isn't going to be sold, its value to a specific buyer isn't particularly relevant. For this reason, the value decided on for a divorce is different. Many of the considerations are the same as for determining the sale value, but there are some substantial differences.

What Value Are You Seeking?

A divorce settlement includes the concept of equitable distribution, which isn't a factor under a fair market value premise. The meaning of equitable distribution varies from state to state. The general idea is that the settlement is decided by the court, which is supposed to determine the most equitable distribution. By contrast, in a sale the parties are presumed able to look out for themselves.

In judging what an equitable distribution is, the courts generally consider the following:

Goodwill. Any elements like professional goodwill may be a significant part of the business, but the courts' stand on whether goodwill is considered a divisible asset varies considerably. This could have an important effect on the value of the business.

Intangible value. What about intangible value besides "goodwill"? Ordinarily, the value of intangibles is based on how much they are expected to contribute to future earnings. This, too, needs to be considered when valuing a business for divorce purposes.

Discounts. Some courts in certain states have expressed reluctance in divorce cases to allow various discounts common to fair market value valuations (welcome to New Jersey). The most important discounts — the lack of marketability followed by the minority interest — are harder to justify when no actual sale is contemplated. These can also include a "key person" discount if that person is one of the spouses and he or she intends to continue working in the business. In addition, some courts, depending on the unique circumstances of the particular case, may not allow discounts for difficulties in getting financing for a buyout, or for poor product diversity or unaudited financial statements. They might argue that these problems are germane only to potential buyers.

Supporting the Value in Court

If the divorce goes to court, the valuator must persuade the court that his or her figure is the most accurate. Whatever method the valuator uses, it must be supportable. Unsubstantiated numbers don't hold up in court.

There's widespread difficulty in discovering a business's true worth for divorce valuations. Business owners who refuse to provide documentation to their spouses' financial advisors can be penalized by the courts, but this doesn't guarantee total honesty. Valuators respond by coming up with creative methods of uncovering information.

Some business owners may deliberately try to undervalue their companies to minimize their spouses' settlements. Deliberately minimizing or even dissipating the value of a business can be hazardous, even if the financial expert can't prove the profits were larger than stated.

Some divorcing spouses attempt to use the amounts of key person insurance on the spouse involved in the business or the terms of a buy-sell agreement as indications of the worth of the business. The agreements and insurance policies could have been set up years before, though. They don't necessarily indicate the business's worth at the time of the divorce. Nonetheless, the courts typically consider buy-sell agreements a factor.

Get Help To Find the True Value

Juggling the many factors that make up a divorce valuation is a specialized area of a business valuator's practice. We are experienced with this type of work. Call us if you anticipate needing a business valuation as part of a divorce settlement.

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